

"[W]e live in a globalized environment and in a country which has enormous fiscal and external deficits. So you have to figure out some way - which I have not done I might add - to protect yourself if we should have a real currency problem here.

I'm not saying what the odds are. I have no idea.

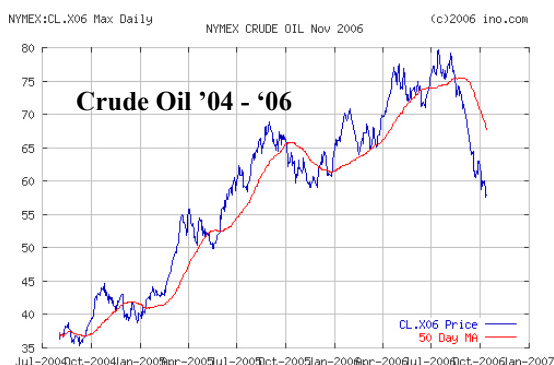
Maybe the odds are very low, but that is one concern."

- Robert Rubin, former Secretary of the Treasury - interview 10/10/06

Has gold market volatility changed the fundamental reasons for physical gold ownership?

Volatility in the gold market is here to stay. Thus far in 2006 gold has been as low as \$525 and as high as \$725, sometimes changing \$50 or more in a single week. Friday, October 13th's price rise of \$12 marks the 50th day this year that gold has moved more than \$10 in a single day in either direction. By comparison, only nine days in all of 2005 showed moves of more than \$10, and all nine occurred in the last three months of the year. This essay offers one possible explanation for this erratic price movement related to the rapid growth of hedge funds and their investment tactics, and also speaks to the mounting systemic risk if these practices continue to proliferate.

"There are more than 8000 hedge funds in the US with \$US 1.2 trillion in assets, more than double the figure five years ago, according to Hedge Fund Research."¹ Despite what their name implies, hedge funds typically concentrate assets into a couple of asset classes, rather than actually "hedging" risk by diversifying exposure. Certain funds have, for example, made very large one-way bets on a rising price of gold. The sheer size of the assets managed by these funds can literally move markets farther than they should have gone as capital flows in, and reverse them more decisively than they otherwise would have as investment pulls out. This unprecedented concentration of capital has resulted in a market phenomenon that some informally refer to as a *rolling bubble*.



To the left three-year graphs are displayed for Gold, Crude Oil and Natural Gas. All three show clear periods of exaggerated up and down trends. Often the up-trend, as is the case with oil, is more gradual, which can be attributed to capital steadily entering a market over a longer period of time. The downward moves, on the other hand, tend to happen much more rapidly, as hedge funds across the spectrum rapidly unwind massive positions that the market cannot absorb.

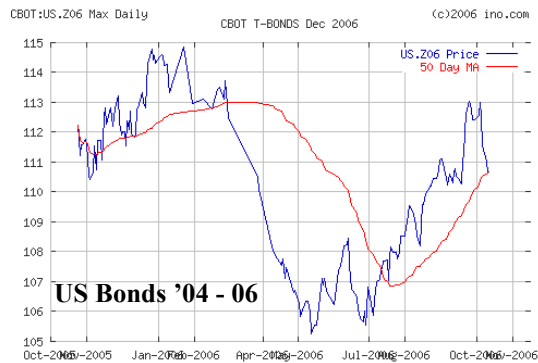
Financial news has been dominated in recent weeks by the story of Amaranth Advisors, a hedge fund that lost \$6.5 billion in a single week making massive wrong way bets on natural gas. Hedge funds like Amaranth, since 2001, had pumped an estimated \$100 billion into commodities, contributing greatly to how far, and how fast, that market appreciated. This year, in the months of August and September, however, more than \$12 billion exited this market, as Amaranth and others unwound losing positions and re-routed funds. All commodities suffered, including gold, as the natural market could not absorb the massive exodus of capital. All in all, a temporary, or *rolling bubble*, had come and passed.

So where did the money go? A look to

¹ <http://www.acnnewswire.net/press/en/33344/Australasian-Investment-Review.html>

² All graphs published with consent from www.ino.com

the graph on the right might offer an explanation. An analysis written by Pinank Mehta of Metier Capital Management contributes an interesting statistic, "The current Long 'Open' Interest in 10-year US treasury bond is greater than SIX Standard Deviations (12 SIGMA)!!!!!! (The odds of a 6-Sigma event are one in 500 million or 1.37 million years, so it will be exponentially higher for a 12 sigma event.)"⁴ An increase of this kind in open interest suggests a massive influx of capital into the bond market on an unprecedented scale, and the market has responded to the upside. Curiously, the fall in commodity prices has also coincided with a new record level in the Dow Jones Industrial Average. Rumors have circulated suggesting the rise was fueled by investments from hedge funds continuing to unwind their commodity positions.⁵ Will these markets be the victims of the next rolling bubble? Time will tell.



What should the average investor take from this information? It is important to highlight that it is not the intention of this essay to encourage predicting these markets or chasing profits through these rolling bubbles. Rather, it is meant to emphasize the systemic threat posed by the enormous, ever-increasing concentration of capital in these funds and their inability to mediate risk. New York Federal Reserve Bank President Timothy Geithner said recently in a speech in Hong Kong, "As existing funds grow larger and their importance increases, distress among those institutions can have greater effects on overall market dynamics, potentially increasing risks to the regulated core."⁶ John Plender of the Financial Times also noted, "...global institutional investment in hedge funds will rise from an estimated \$361bn today to more than \$1,000bn in 2010...Hedge funds are not ideal vehicles to take big bets on market fundamentals. Amaranth...was taking a leveraged bet that exceeded its capacity for liquidity... The wider problem is that if the wrong people are taking the wrong risks, the financial system becomes more fragile."⁷ As the amount of capital managed by hedge funds continues to grow, mismanaged risk resulting in Amaranth-like failures could cause significant shocks within all markets. The instability brought on by these failures certainly deserves attention, and diversification within your portfolio has never been more important.

This piece led off with a quote by former Secretary of the Treasury, Robert Rubin. In the same piece, Rubin refers to a prediction made by Paul Volcker that there is a 75% chance of a major financial crisis within the next five years in the United States.⁸ When you combine the mounting systemic risk posed by hedge funds with the enormous fiscal and external deficits Rubin mentions, it is not surprising that he advises protecting yourself in the event of a currency problem. As our clientele already know, in the end, there is only one asset that will truly insulate a portfolio against shocks of that magnitude to the economy and monetary system. Gold.

The recent move in the gold price, likely accentuated by hedge fund involvement, has done nothing more than create a classic buying opportunity in the yellow metal. Price volatility will likely remain a steadfast characteristic of this market, but should not distract from the unchanged, fundamental reasons to own the metal. It should be taken advantage of. The price of gold has been relatively stable in recent weeks, reminiscent of the days of \$250 gold when the market was quiet, and attention had waned. That said, you would be hard pressed to find a single person who wouldn't jump at the chance to buy gold below \$300 an ounce. Perhaps, in the years to come, investors will have the same sentiment with regards to \$600 gold, and the period of relative calm we find ourselves in right now.

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³All Amaranth data: <http://www.acnnewswire.net/press/en/33344/Australasian-Investment-Review.html>

⁴<http://www.fiendbear.com/061006%20Record%20Long%20'Open'%20Interest%20in%20US%20Bonds>

⁵ <http://www.resourceinvestor.com/pebble.asp?relid=24503>

⁶<http://www.bloomberg.com/apps/news?pid=20601087&sid=an02p3jWWNJk&refer=home>

⁷ John Plender "The wrong kinds of risk the hedge funds take on," Financial Times, October 16, 2006.

⁸ All Robert Rubin references taken from an interview conducted by Citigroup Financial, www.citigroup.com, on October 10, 2006